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Financing for development: Debt and debt sustainability and interrelated systemic issues

Note by the UNCTAD secretariat*

Executive summary

This note provides an overview of the recent evolution of developing country debt indicators and analyses core challenges to debt sustainability in the context of interrelated systemic issues in the international economy, such as debt-driven global growth dynamics and continued international financial integration. Further, it discusses a range of policy options to mitigate growing debt vulnerabilities in developing economies, at international as well as national levels. These include debt crisis prevention and resolution, where current debt burdens have already become unsustainable. The discussion emphasizes the need for a holistic approach to policy responses at the global and domestic levels, as well as for a differentiated approach to developing countries at different stages of structural transformation.

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I. Introduction

1. At the first session of the Intergovernmental Group of Experts on Financing for Development, held in Geneva, Switzerland on 8–10 November 2017, it was decided that the topic of its second session, to be held in Geneva on 7– 9 November 2018, should be "Debt and debt sustainability and interrelated systemic issues". Agreed guiding questions for this second session of the Intergovernmental Group of Experts are as follows: [1]

(a) How can current debt vulnerabilities in developing countries be mitigated and developing country sovereign debt and financial crises be prevented?

(b) How can sovereign financing, both external and domestic, be leveraged successfully for sustainable development in future?

(c) What institutional, policy and regulatory changes are required at the international level to ensure that global economic governance structures better support the use of responsible financing, by borrowers and lenders, for sustainable development?

(d) How can existing frameworks and tools be improved to ensure effective, fair and transparent sovereign debt crisis resolution?

2. This discussion topic corresponds to action areas II.E and II.F of the Addis Ababa Action Agenda. Action area II.E of the Agenda recognizes the need to assist developing countries in attaining long-term debt sustainability "through coordinated policies aimed at fostering debt financing, debt relief, debt restructuring and sound debt management, as appropriate" (paragraph 94). It calls for strengthening analytical tools to assess developing country debt sustainability and highlights the need for improved public data availability and debt management capacities to ensure adequate risk management (paragraphs 95 and 96), in addition to enhanced cooperation between creditors and debtors to prevent debt crises and to resolve these effectively once they occur (paragraphs 97–100). Emphasis is also placed on the growing complexity of debt contracts and financing instruments in different currency denominations (paragraphs 100 and 101) and on the plight of environmentally vulnerable developing countries facing particular challenges to their debt sustainability in the context of frequent natural disasters (paragraph 102). Action area II.F of the Agenda recalls the importance attributed to global economic governance reform under the Monterrey Consensus of the International Conference on Financing for Development (2002) and acknowledges the need to strengthen international financial regulation and to mitigate financial and commodity price volatility (paragraphs 104, 105, 107, 109 and 110). It also commits to "broadening and strengthening the voice and participation of developing countries in international economic decision-making and norm-setting and global economic governance" (paragraph 106).

3. This note provides an overview of main trends in the recent evolution of global developing country debt indicators and summarizes core challenges and policy options at the national and international levels.

II. Growing debt vulnerabilities in developing countries

A. Debt-driven global growth and mounting financial fragilities

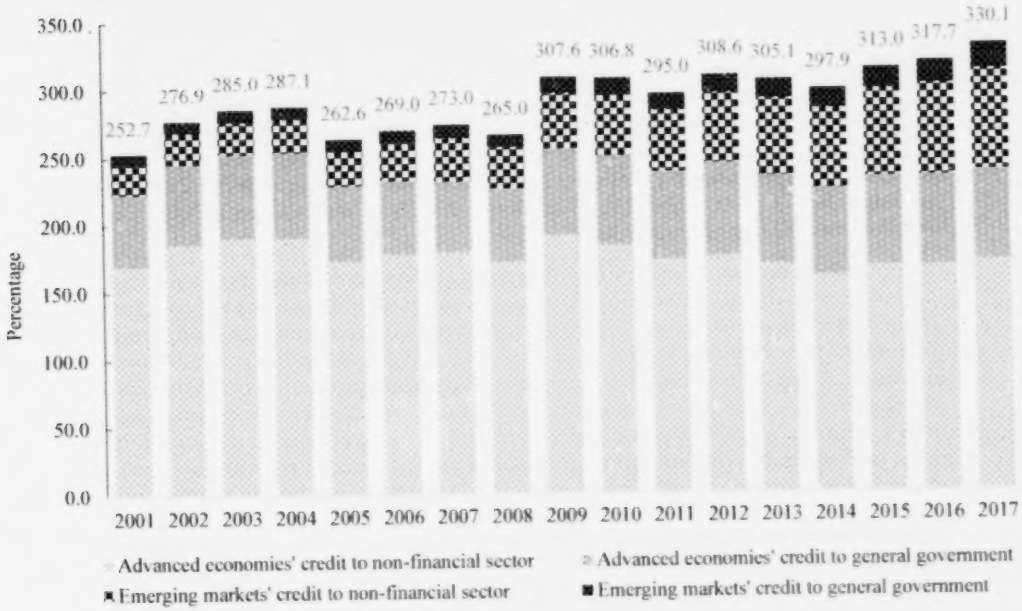
4. A decade after the global financial crisis, global debt levels continue to reach new record highs (see figure). The Institute of International Finance estimates that by the end of March 2018, global debt stocks had reached $247.2 trillion, up from $168 trillion at the onset of the financial crisis of 2007–2008 and by nearly $25 trillion from a year earlier.[2] UNCTAD estimates that the ratio of global debt-to-world gross domestic product (GDP) is nearly one third higher than in 2008, with global debt stocks amounting to more than three times global

[1] TD/B/EFD/1/3, annex I.

[2] Institute of International Finance, 2018, Global Debt Monitor database, July; Bloomberg, 2018, Global debt topped $247 trillion in the first quarter, IIF [Institute of International Finance] says, 10 July. Estimates by the Institute of global debt stock are based on household, nonfinancial sector, corporate financial and public sector debt for 72 countries.

GDP. The high dependence of a modest global recovery on debt reflects systemic fragilities in global growth dynamics that have persisted, despite the profound shock of the financial crisis. In a policy context where the burden of recovery has shifted to strongly accommodative monetary policies by central banks in lead economies, global economic growth has remained heavily reliant on easy financing conditions and short-term expectations of appreciations in asset values.

Global debt by components, *2001–2017*
(Percentage of world gross domestic product)



Source: UNCTAD secretariat calculations based on statistics of the Bank for International Settlements; global debt calculated as credit to non-financial sectors from all sectors and credit to general government at market values.

Note: Advanced economies: Australia, Canada, Denmark, euro area, Japan, New Zealand, Norway, Sweden, Switzerland, United Kingdom and United States. Emerging market economies: Argentina, Brazil, Chile, China, Colombia, Czechia, Hong Kong (China), Hungary, India, Indonesia, Israel, Republic of Korea, Malaysia, Mexico, Poland, Russian Federation, Saudi Arabia, Singapore, South Africa, Thailand and Turkey.

5. While core banking sectors in most developed economies have consolidated their positions and deleveraged substantially, regulatory loopholes have facilitated the re-emergence of unregulated financial credit default swap (insurer) markets "in the shadows", significantly augmenting the danger of cascading financial vulnerabilities in the event of a collapse of underlying markets.[3] More generally, the financialization trends that led to financial collapse a decade ago – high profitability in financial sectors outpacing that in real sectors, a growing dependence of non-financial firms on financial activities for their revenue flows, the prevalence of short-term investment strategies (including mergers and share buy-backs), as well as consumer behaviour tied to asset bubbles and easy access to credit – continue to thrive. An additional source of concern is the widely observed sharp increase in

[3] M Greenberger. 2018. Too big to fail U.S. [United States] banks' regulatory alchemy: Converting an obscure agency footnote into an "At Will" nullification of Dodd-Frank's regulation of the multi-trillion dollar financial swaps market. Institute for New Economic Thinking Working Paper No. 74.

market concentration in leading non-financial (especially high-technology) sectors.[4] Together, these trends result not only in heightened financial fragilities, but in persistent downward pressures on aggregate demand, income and employment and thus slow global growth.

6. The abundance of cheap credit has favoured booming cross-border private capital flows. Such booms failed to support global capital formation in the 1990s, and their volatility and procyclicality – inflows of cheap credit in good times and sudden large outflows of capital at the first sign of potential difficulties – were a core cause of developing country financial and currency crises at the time, such as the Asian financial crisis of 1997. The post-crisis period has not seen any progress in improving the management of private capital flows for purposes of longer-term productive investment and development. Not only are private cross-border capital flows today at least as volatile as in the 1990s, they involve larger magnitudes and more pronounced reversals.[5] Such reversals – sudden stops – are increasingly driven by external and global factors,[6] such as changes to global liquidity and risk, tightening financial conditions and appreciations of the dollar, rather than by country-specific factors. An important implication is that developing countries' debt sustainability has, on average, been affected by private capital flow reversals, whether or not Governments promoted strong economic fundamentals, such as relatively low public debt, small budget deficits, low inflation rates and high reserve holdings.

7. At the same time, the sectoral dynamics driving ballooning debt burdens and potential debt crises have changed. A decade ago, unsustainable household debt in the United States of America and excessive borrowing by financial institutions triggered disaster. Even though debt-fuelled household consumption is again on the rise in the United States,[7] this renewed expansion of debt has been muted by incomplete deleveraging processes from debt burdens accumulated prior to the global financial crisis. The main focus of worry has instead shifted to fast rising non-financial corporate debt in developed and larger emerging economies, with corporate bond markets and non-bank intermediaries playing an increasingly important role. According to Standard and Poor Global, corporate non-financial debt has grown faster than nominal GDP for much of the past decade. Globally, over one third of non-financial corporations are now highly leveraged with gearing (debt-to-earnings) ratios of 5 and above, up from only 5 per cent in 2007, while non-investment-grade corporate bonds have quadrupled since 2008.[8] Corporate bond markets have grown particularly fast in large emerging economies in Asia and Latin America, with around 20–25 per cent of corporate bonds at growing risk of default ,despite still relatively low interest rates.[9]

B. Evolution and dynamics of rising debt burdens in developing countries

8. This fragile financial and economic environment poses serious challenges for developing country debt sustainability. While the bulk of global debt is still held in developed countries, emerging and developing country debt rose from just under 40 per cent of global GDP in 2008 to 93.2 per cent in 2017. For developing countries as a whole, total external debt stocks are estimated to have reached $7.64 trillion in 2017, having grown at an average yearly rate of 8.5 per cent between 2008 and 2017, or more than 80 per cent over the period.

[4] F Diez, D Leigh and S Tambunlertchai, 2018, Global market power and its macroeconomic implications, International Monetary Fund Working Paper No.18/137; UNCTAD, 2017, *Trade and Development Report 2017: Beyond Austerity towards a Global New Deal* (United Nations publication, Sales No. E.17.II.D.5), chapter VI.

[5] B Eichengreen, P Gupta and O Masetti, 2017, Are capital flows fickle? Increasingly? And does the answer still depend on type? World Bank Policy Research Working Paper 7972 ,B Eichengreen and P Gupta, 2016, Managing sudden stops, World Bank Policy Research Working Paper 7639.

[6] E Cerutti, S Claessens and D Puy, 2015, Push factors and capital flows to emerging markets: Why knowing your lender matters more than fundamentals, International Monetary Fund Working Paper No. 15/127.

[7] Reuters, 2018, Mortgage, groupon and card debt: How the bottom half bolsters U.S. [United States] economy, 23 July.

[8] Standard and Poor's Global, 2018, Global corporate leverage trends 2018, 5 February.

[9] S Lund, J Woetzel, E Windhagen, R Dobbs and D Goldshtein, 2018, Rising corporate debt: Peril or promise? McKinsey Global Institute Discussion Paper.

Over the same period, total external debt stocks increased from $155 billion to $293.4 billion in the least developed countries, representing an average annual growth rate of 7.4 per cent. Emerging economies registered a slightly higher average growth rate at 9.5 per cent of their external debt stocks.[10]

9. For all developing countries, the debt-to-GDP ratio rose from 21.8 per cent in 2008 to 25.7 per cent in 2017.[11] However, this aggregate figure masks more worrying trends in a growing number of developing countries. According to the International Monetary Fund, by 2017, debt-to-GDP ratios had climbed to above 70 per cent in one fifth of emerging and middle-income countries and to above 60 per cent in one fifth of low-income developing countries.[12] Including implicit liabilities, such as pension and health care spending, these figures increase to 112 per cent for emerging and middle-income countries and to 80 per cent for low-income countries, respectively.[13] Based on the International Monetary Fund's debt sustainability analysis for developing countries eligible under its Poverty Reduction and Growth Trust,[14] some 40 per cent of low-income developing countries now face significant debt-related challenges, up from 21 per cent in 2013. By mid-2018, the number of low-income developing countries at high risk of debt distress or already in debt distress had risen from 13 in 2013 to 31 (24 at high risk and 7 in debt distress). These categories include 14 of the 34 low-income developing countries that received debt relief under the Heavily Indebted Poor Countries Initiative or the Multilateral Debt Relief Initiative.[15]

10. An immediate implication of rising debt ratios are higher debt service burdens, even under favourable financing conditions. For developing and transition countries as a group, the debt-service-to-export ratio rose from 8.7 per cent in 2011 – its lowest point since the onset of the global financial crisis – to 15.4 per cent in 2016. In 2017, this fell to 13.6 per cent, largely due to a recovery of some commodity prices since mid-2016. In the least developed countries, this ratio also saw a pronounced increase from 4.1 per cent in 2008 to almost 10 per cent in 2017, and in sub-Saharan Africa it more than tripled from 3.8 per cent in 2011 to 12.9 per cent in 2017. In poorer economies, interest payments as a percentage of government revenue more than doubled from 5.7 per cent in 2008 to 14 per cent in 2017, and to 18.5 per cent in sub-Saharan Africa, reaching as much as 30 per cent of tax revenue in some sub-Saharan economies. This is approaching debt service burdens last seen prior to the onset of the debt relief initiatives of the early 2000s.[16] Further signs of difficulty include a growing share of short- relative to long-term debt in total external debt stocks, coupled with a significant slowdown in the growth of international reserves.

11. These developments effectively reverse the substantial achievements of the 2000s in developing country debt sustainability, when average regional debt-to-GDP ratios fell to levels ranging from 40 per cent to less than 20 per cent across the developing world, and debt service costs also declined significantly. In addition to the debt relief initiatives of the 1990s and 2000s, growth-oriented macroeconomic policy and public debt management played a role in strengthening external debt sustainability in many developing countries. Equally important were, however, highly favourable external factors, such as low international borrowing costs and booming demand for many developing country exports, allowing Governments to reduce both fiscal and external deficits.

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[10] UNCTAD secretariat calculations based on World Bank online database, International Debt Statistics 2018.

[11] Ibid.

[12] The United Nations least developed country grouping and the International Monetary Fund low-income developing country grouping contain practically the same list of countries, the major difference being that Nigeria and Viet Nam are included in the Fund's list.

[13] International Monetary Fund, 2018, *Fiscal Monitor: April 2018 – Capitalizing on Good Times*, Washington, D.C.

[14] See current International Monetary Fund list of low-income countries' debt sustainability assessments for countries eligible for the Trust, available at www.imf.org/external/Pubs/ft/dsa/DSAlist.pdf (accessed 5 July 2018).

[15] International Monetary Fund, 2018, Macroeconomic developments and prospects in low-income developing countries: 2018, International Monetary Fund Policy Paper.

[16] UNCTAD secretariat calculations based on World Bank online database, International Debt Statistics 2018.

12. This upward momentum did not last for reasons that are familiar from earlier episodes of developing country debt and financial distress in the 1980s and 1990s: Recessions in advanced economies – in this case triggered by the global financial crisis – and, more broadly, sluggish global aggregate demand, undermine developing countries' ability to service existing external debt in the international lead currency. Procyclical cross-border flows of cheap international credit cause financial instability in developing countries, whether or not they are already highly indebted; volatile commodity markets, themselves affected by financial instabilities, speculation and economic downturns, add to the turmoil.

13. Debt sustainability in commodity-dependent developing countries has been heavily affected by the most recent slump in commodity prices, since 2011. The recent increase in average commodity prices, driven largely by a sustained fuel price rise since 2017, has brought some relief, although commodity prices remained below their 2011 peak levels. The most important common denominator of rising debt vulnerabilities across developing countries is that the more conventional triggers of debt distress have been amplified by the rapid integration of developing countries' shallow financial and banking systems, both public and private, into volatile and largely unregulated international financial markets. With international public finance flows falling short of commitments and limited access to concessional resources, [17] developing countries have increasingly raised finance on commercial terms in developed country financial markets and have opened their domestic financial markets to non-resident investors. Developing countries have also allowed their citizens to borrow and invest abroad.

14. This has entailed pronounced shifts in the composition of developing country debt, increasing their exposure to market risk and amplified refinancing risks substantially, for example in the form of shorter maturity periods. For developing countries taken together, the share of public and publicly guaranteed external debt owed to private creditors rose from just above 40 per cent in 2000 to well over 60 per cent in 2017. Bond debt, as opposed to bank-related debt, now constitutes a large share of public and publicly guaranteed developing country debt, having increased from 24 per cent in 2000 to 43 per cent in 2014. [18] By 2016, 46 per cent of the total debt of low-income developing countries – twice that of 2007 – had been financed through non-concessional channels with external borrowing from commercial creditors growing rapidly from a low base. [19] This increase in the issuance of sovereign bond debt has been a driving factor in sharply growing debt servicing costs as capital flow reversals imposed high-yield increases on developing country international sovereign bonds. [20]

15. Throughout the 2000s, there has also been a marked shift from public and publicly guaranteed towards private non-guaranteed debt, with the share of private non-guaranteed debt in developing country external debt rising from 28 per cent to almost half of total external debt between 2000 and 2009. Initially led by South and South-East Asian economies, this pattern of debt composition spread to sub-Saharan Africa, where the share of private non-guaranteed debt in total long-term external debt stocks increased sevenfold in the first 15 years of the millennium, from $10 billion to $70 billion. [21] Non-financial corporate debt in emerging market economies has now risen to over $30 trillion or just under 95 per cent of combined GDP, surpassing comparable levels for developed markets. [22] The dangers

[17] Net official development assistance by members of the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD) continued to fall short of the United Nations target of 0.7 per cent of donor gross national income, amounting to $146.6 billion in 2017, or a decrease in real terms of 0.6 per cent, compared with 2016. Official development assistance flows to the least developed countries have stagnated in recent years. See for example, OECD, 2018, Development finance data, available at www.oecd.org/dac/financing-sustainable-development/development-finance-data/ (accessed 5 July 2018).

[18] A/71/276.

[19] International Monetary Fund, 2018, *Fiscal Monitor: April 2018 – Capitalizing on Good Times*, Washington, D.C.

[20] An example is Zambia, which issued $1.25 billion at 11.4 per cent in 2015 compared with 5.63 per cent for an issuance in 2012. Similarly, Mozambique paid a yield of 16.26 per cent for an international bond issuance in June 2016, compared with much lower yields a few years earlier.

[21] A/71/276.

[22] J Wheatley, 2018, Upturn in global debt to pile pressure on emerging markets, *Financial Times*, 11 July.

associated with high levels of corporate debt are obvious: Outside China, where corporate bonds are predominantly domestically owned, large developing country corporates rarely manage to hedge their foreign-currency debt exposure appropriately through assets held abroad. Their liabilities are therefore ultimately backed by foreign currency reserves in the domestic economy. If private sector external debt becomes unsustainable, Governments often have no choice but to transfer the bulk of this debt onto public balance sheets.

16. The substantial share of foreign currency denominated debt in general government debt (amounting to around one third of higher-income and two thirds of low-income developing countries' general government debt)[23] means exchange rate risks heighten the challenge to developing country debt sustainability across the board.

17. Developing country Governments have sought to address rising debt service costs for sovereign bonds issued in international currency by shifting to domestic debt in local currency. Data for 65 developing and emerging countries from the Bank for International Settlements shows that the share of domestic debt securities in total debt securities rose from around 56 per cent in 2000 to 87 per cent in 2015. For a subset of 21 countries for which this data are available, domestic debt issues by central Governments increased more than tenfold, from $518.3 billion in 2000 to $5.3 trillion in 2015.[24] While Governments can reduce their vulnerability to exchange rate volatility in this manner, high-risk exposure to sudden reversals in capital flows is not reduced if foreign holdings of domestic debt are high. Moreover, developing countries switching from external to domestic public debt often involves trading a currency for a maturity mismatch; as such, countries are unable to issue long-term government securities at a sustainable rate of interest, yet need to be in a position to pay off or roll over maturing and short-term obligations.

18. In short, in a global economic environment dominated by largely unregulated international financial markets and the ad hoc sensitivity of financial players to day-by-day economic news, developing countries have limited policy space to leverage debt sustainably for long-term development strategies. Instead, such strategies, whether reliant on international sovereign bond issuance, domestic bond markets or corporate debt, are likely to be thwarted by sudden reversals of international cheap credit flows in response to changes in policy variables beyond the control of developing country Governments, as well as subsequent domestic capital flight. Debt burdens that seemed reasonable under favourable conditions can quickly become unsustainable, not only because debt service costs for non-concessional debt instruments can rise at short notice. For example, once a debt crisis, brought on by the procyclical nature of private capital flows originating in unregulated international financial markets takes hold, currency devaluations to improve export prospects simultaneously increase the value of foreign-currency denominated debt. For commodity exporters, the need to meet rising debt servicing requirements also generates pressure to continue to produce, potentially worsening excess supply constraints and downward pressures on commodity prices.

The plight of middle-income developing countries and small developing island States

19. Rising debt vulnerabilities due to fast global financial integration and recurrent cycles of financial instability are generic to developing countries, independently of their average per capita income status. The unfolding currency and debt crises in Argentina, Turkey and other large developing countries are a stark reminder of this fact. As the Agenda recognizes explicitly, middle-income developing countries "still face significant challenges to achieve sustainable development" (paragraph 71). Explanations have ranged from structural factors that create developmental turning points,[25] to more general considerations about growing obstacles to continued economic diversification in the current volatile and slow-growth global economy in combination with greater demands on middle-income countries'

[23] International Monetary Fund, 2018, *Fiscal Monitor: April 2018 – Capitalizing on Good Times*, Washington, D.C.

[24] Bank for International Settlements International Banking and Financial Statistics database, 2016; A/71/276.

[25] For example, such turning points include upward pressures on real wages as cheap surplus labour from traditional sectors of the economy is being absorbed into modern manufacturing sectors and skill bottlenecks that render climbing up the technology ladder more difficult from a certain point onwards.

institutional and political capacities to respond to rising investment requirements associated with late industrialization pushes.[26]

20. Structural stagnation in middle-income developing economies is compounded not only by protracted sluggish growth of the global economy, but also by growing leverage and maturity mismatches arising from the haphazard integration of their evolving productive and financial structures into international financial markets. The advantage of accessing a broader range of financing and debt instruments in international capital markets can be outweighed by capacity constraints in assessing the risks attached to these and by non-eligibility to concessional financing and debt relief initiatives. Exclusion from such eligibility based on crude per capita income thresholds overlooks the fact that these economies remain home to the majority of the world's poor.[27] Many small island developing States, which are mostly also middle-income countries, face additional constraints arising from their growing and increasingly regular exposure to natural disasters. The total external debt stocks of such States more than doubled between 2008 and 2017, with their average debt-to-GDP ratios increasing from 28.3 per cent in 2008 to 58.2 per cent in 2017, and well above 100 per cent in some cases. Average debt service-to-exports ratio also worsened substantially from 8.6 per cent in 2008 to 19.2 per cent in 2017, while the ratio of external debt to exports rose from 67.4 per cent to 163.8 per cent of GDP. Public finances have continued to be stifled by heavy debt servicing costs, which accounted for 16 per cent of government revenue in 2010, and more than doubled to 40 per cent in 2015.[28] While the international community has to an extent recognized the need to pay specific attention to the plight of small island developing States facing recurrent debt and financial distress in the wake of their environmental vulnerability, a more encompassing multilateral approach to address systematic underinvestment in climate change adaptation in the long term – and an inappropriate reliance on domestic resource mobilization and short-term insurance mechanisms – will be required.

III. Debt crisis prevention: International and national policy options

21. External financing through debt-related mechanisms is a key element of any development strategy as developing country productive and financial structures become increasingly complex. With global financial integration continuing apace, the question for policymakers, in developing countries and the international community alike, is how to harness the potential of external finance, including debt, to support national development strategies, while minimizing the risks arising in an uncertain and volatile global economic environment.

22. Addressing policy dilemmas arising from growing developing country debt vulnerabilities is all the more important in view of the challenges posed by the timely implementation of the 2030 Agenda for Sustainable Development. While estimates vary, there is general agreement that investment requirements in this regard range in the trillions rather than millions.[29] Yet for some developing countries, the resources currently dedicated to debt-servicing represent several times the budget allocation for Sustainable Development Goal-related investments.[30]

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[26] UNCTAD, 2016, *Trade and Development Report 2016: Structural Transformation for Inclusive and Sustained Growth* (United Nations publication, New York and Geneva), pp. 40-41; R Doner and B Schneider, 2016, The middle-income trap: More politics than economics. Massachusetts Institute of Technology Working Paper.

[27] World Bank, 2016, Assisting middle-income countries in their quest to turn "billions to trillions", 25 July, available at www.worldbank.org/en/news/feature/2016/10/25/assisting-middle-income-countries-in-their-quest-to-turn-billions-to-trillions (accessed 5 July 2018).

[28] UNCTAD secretariat calculations based on World Bank online database, International Debt *Statistics 2018*.

[29] G Schmidt-Traub, 2015, Investment needs to achieve the sustainable development goals: Understanding the millions and trillions, Sustainable Development Solution Network Working Paper.

[30] Estimates based on Government Spending Watch database, 2018 (www.governmentspendingwatch.org/spending-data, accessed 5 July 2018).

23. The fact that developing countries have experienced a continuous net negative transfer of their resources to developing nations in recent decades serves to underline the magnitude of the challenge. One estimate suggests that since 1980, developing countries have been net providers of resources to the rest of the world, amounting to about $16.3 trillion.[31] As the United Nations highlighted early on,[32] external debt has played a central role in this dynamic of net negative resource transfers from the developing to the developed world, with the increasing reliance on (re-)financing such debt in international financial markets rather than through bi- and multilateral channels exacerbating matters. These concerns have recently been echoed by research that emphasizes the drain on developing country resources arising from persistent negative differentials between the rate of return on their foreign assets, compared with their foreign liabilities, contrary to positive differentials in this regard for developed economies.[33] There is also growing disquiet about illicit financial outflows from developing countries, accumulating in a context of fast evolving international production and value chains insufficiently governed by international tax cooperation to facilitate developing countries' control of tax revenues arising from their participation in global production.[34]

A. The international arena: Main policy challenges and options

The international monetary and financial system: Strengthening development-friendly features

24. Given the global nature of many of the determinants of developing country debt sustainability, policy reform at the level of international monetary and financial governance is indispensable. Key functions of the international monetary system are to provide international liquidity required for balanced productivity and employment growth across economies and to balance international policy coordination with the need for national policy space.

25. At present, developing countries are required to maintain stable access to international liquidity while, at the same time, the availability and terms of international liquidity remain beyond their control. This asymmetry[35] in the current international monetary system results in developing countries having to seek additional external financing – exposing them to higher risks of balance of payments crises, while exchange rate volatility has adverse impacts on trade and investment decisions. In the absence of an encompassing global financial safety net to provide a backstop to countries affected by sudden changes in global trade and financial conditions, the burden of adjustment to growing macroeconomic imbalances rests with deficit economies through the adoption of growth-restricting austerity programmes and costly self-insurance schemes through high accumulation of foreign exchange reserves.

26. A development-friendly international monetary system would avoid such waste of resources and proactively facilitate structural transformation in developing countries through mechanisms that support their long-term access to foreign demand, thus reliable export markets, to allow them to repay external debt, and by systematically encouraging high-productivity surplus economies to recycle their surpluses to lower-productivity countries. Such recycling takes the form of expansionary policies at home to stimulate domestic demand for imports from lower-productivity deficit economies, of investing into these economies (rather than piling up international reserves or investing surpluses in international financial markets) and of lending to lower-productivity economies on reasonable, or even concessional, terms.

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[31] Global Financial Integrity, 2016, Financial flows and tax havens: Combining to limit the lives of billions of people, 5 December, available at www.gfintegrity.org/report/financial-flows-and-tax-havens-combining-to-limit-the-lives-of-billions-of-people/ (accessed 5 July 2018).

[32] A/42/272-E/1987/72.

[33] Y Akyüz, 2017, External balance sheets of emerging economies: Low yielding assets, high-yielding liabilities, The South Centre; See International Monetary Fund, 2018, *External Sector Report: Tackling Global Imbalances amid Rising Trade Tensions*, Washington, D.C.

[34] TD/B/EFD/1/2.

[35] JA Ocampo, 2017, *Resetting the International Monetary (Non)System*, United Nations University World Institute for Development Economics Research, Oxford University Press, Oxford and Helsinki.

27. While technical proposals to shift the burden of international monetary adjustment at least partially to high-productivity surplus economies with a view to stimulating aggregate global demand in the longer run have been made in the past,[36] these invariably fall short of the multilateral policy consensus required for their implementation. A more realistic remedial measure to at least alleviate current limitations to the provision of more stable international liquidity focuses on reforms of the issuance and allocation of special drawing rights to provide additional international development finance. Special issuances of these financing instruments for this purpose would help release domestic resources for development by reducing international reserve requirements and ease access to development finance on concessional lower-risk terms.[37]

28. Regulatory reforms to stabilize international financial markets have made only muted progress. In the absence of more concerted international policy action to reign in financialization, developing countries are well advised to consider the adoption of capital control measures as a key management mechanism of financial flows and external debt burdens over global credit and financial cycles. Additionally, proactive debt management policies to lock down favourable financing conditions over long periods of time are essential.[38] But continued instability in international financial markets also has implications for the international agenda on financing for development with its strong emphasis on blended financing instruments. Clearer rules for the design of such financing tools must precede their widespread promotion to avoid the risk of carrying over the short-termism prevalent in unregulated international financial markets into the arena of development financing, with direct adverse impacts on developing country debt sustainability. Regulatory tools to facilitate binding commitments to the re-investment of private proceeds from blended financing projects in developing countries may help to mitigate such impacts. Additional avenues to easing developing country access to development finance and therefore to more sustainable debt burdens include developed countries' commitment to their outstanding official development assistance obligations and their support for significant capital increases for multilateral development banks. Similarly, supporting regional mechanisms, such as regional clearing unions and related financial arrangements, deserve further attention.

29. International efforts to address growing concerns about unsustainable debt burdens in the developing world has focused on the promotion of soft law principles to encourage responsible sovereign lending and borrowing on a voluntary basis.[39] The UNCTAD Principles for Responsible Sovereign Lending and Borrowing (2012) led the way in this regard and remain the most encompassing normative framework available to guide best practice in sovereign lending and borrowing, based on the application of established international legal norms and custom, such as transparency, legitimacy, impartiality, good faith and sustainability.[40] The Principles are the result of extensive legal and economic research, as well as a wide-ranging consultation process including over 70 creditor and debtor member States, the International Monetary Fund, the World Bank, OECD and the Paris Club among others. Further, the Principles have been noted in the Agenda, welcomed in numerous resolutions of the United Nations General Assembly and are a standard reporting item in the Inter-Agency Task Force Report on Financing for Development Review and Follow-up. Recent related initiatives, such as the Group of 20 Operational Guidelines on Responsible Financing (2017),[41] focus on best practice and policy prescriptions from the perspective of the sustainability of market-based and innovative financing tools and policies.

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[36] M Amato and L Fantacci, 2014, Back to which Bretton Woods? Liquidity and clearing as alternative principles for reforming international money, *Cambridge Journal of Economics*, 38(6):1431–1452; X Zhou, 2009, Reform the international monetary system, People's Bank of China, 23 March.

[37] Department of Social and Economic Affairs, 2012, *World Economic and Social Survey 2012: In Search of New Development Finance* (United Nations publication, Sales No. E.12.II.C.1, New York).

[38] Department of Social and Economic Affairs, 2018, Navigating financial risks through macroprudential policies: Recent experiences of emerging economies, Policy Brief No. 57.

[39] A/72/253.

[40] For a detailed discussion of these principles, see JP Bohoslavsky and M Goldmann, eds., 2016, Special Edition on Sovereign Debt, *The Yale Journal of International Law*, 42(2).

30. Such soft law initiatives aim to broaden consensus on what constitutes responsible behaviour by both lenders and borrowers to reduce the likelihood of sovereign debt crisis, as well as to promote shared responsibilities, a more transparent process and fairer and more efficient outcomes for debt crisis resolution. While, by definition, soft law principles are not legally binding and rely on voluntary adherence, the establishment of a broad consensus can play an important role by paving the way towards regulatory convergence at the national and international levels and eventual reform of legally enforceable frameworks. There are different, but in principle complementary, methods to enhance the effective implementation of normative frameworks and best practice guides. These could be incorporated in advance into contract choice of law clauses for sovereign debt bonds; coordinated efforts could be stepped up to facilitate their dissemination and the build-up of national institutional and regulatory mechanisms for systematic implementation; and adjudicative bodies – domestic courts or arbitral tribunals – could take such guidelines into consideration in their own actions and decision-making.

31. Finally, and where debt burdens are becoming clearly unsustainable due to exogenous (capital flow, commodity price or environmental) shocks, renewed debt relief initiatives for highly vulnerable countries may have to be considered. This would require improved criteria to determine eligibility and amounts of debt relief that go beyond simple metrics based on GDP per capita levels, as well as the design of mechanisms to align the benefits derived from debt relief with Sustainable Development Goal-related investment. For instance, contingent swap mechanisms, such as climate change swap proposal of the Economic Commission for Latin America and the Caribbean or the ex-post determination of concessionality conditions, can help to ensure the efficient use of debt relief in beneficiary countries.

Frameworks to assess developing country debt sustainability

32. Definitions of what constitutes sustainable debt burdens have direct implications for policy design to address critical situations. The standard definition of debt sustainability focuses on the consistency of a set of macroeconomic and policy variables with debt stabilization, that is, with a situation in which there is no need of default, debt restructuring or implausibly large adjustment measures.[42] This approach is characterized by a focus on short-term debt dynamics based on medium-to long-term projections of macroeconomic performances with problematic policy implications. As has often been pointed out,[43] not only do long-term macroeconomic projections suffer from large forecast errors, but strong emphasis on short-term policy variables such as primary fiscal surpluses can prioritize self-defeating fiscal contraction policies that undermine longer-term growth prospects and debt sustainability by compelling countries to reduce long-term investment to levels consistent with short-term debt payment obligations. The emphasis on short-term prioritization of creditors' claims over investment for long-term development goals sets this standard approach to defining and assessing debt sustainability at odds with the achievement of the 2030 Agenda for Sustainable Development. Consideration should therefore be given to alternative frameworks that define debt sustainability relative to longer-term development goals and that make trade-offs between debt burdens and fiscal space subject to explicit policy considerations, including the need for developing countries to allocate an increasing share of their resources towards the 2030 Agenda.

B. National policy challenges and options

33. With debt burdens across developing countries reaching critical levels, domestic debt management becomes particularly important. Much recent interest in this regard has focused on debt instruments that help mitigate exogenous shocks to developing

[42] International Monetary Fund, 2013, Staff guidance note for public debt sustainability analysis in market-access countries, 9 May.

[43] U Panizza, 2015, Debt sustainability in low-income countries: The grants versus loans debate in a world without crystal balls, Fondation pour les études et recherches sur le développement international Working Paper 120; O Blanchard, 1990, Suggestions for a new set of fiscal indicators, OECD Economics Department Working Paper No. 79.

economic – such as State-contingent debt instruments.[44] These are financial instruments whose payoffs are contractually linked to a State variable (such as GDP, inflation or commodity prices) or to a trigger event (such as a natural disaster or a health epidemic). Designed to improve debt management by linking the debt service of a developing country to its capacity to pay as a function of such variables, State-contingent debt instruments can help to provide liquidity relief at times of stress in international financial markets, as well as reduce the likelihood of costly debt restructurings by providing an automatic mechanism of adjustment. Despite these potential benefits, adoption so far has been limited to few instances involving catastrophe bonds and climate change bonds.[45] The main challenge for State-contingent debt instruments is to establish investor confidence in these instruments. Raised risk premiums related to moral hazard, novelty, and data quality and transparency have kept market participants at bay, and the markets for these instruments are either highly illiquid or non-existent. Current experience would point to the importance of active participation by multilateral development banks and donor countries to create the conditions required for a more systematic adoption of such instruments.

34. While the development of domestic bond markets is an important part of the evolution of domestic debt management capacities, switching from external to domestic borrowing is not a panacea for fending off growing debt vulnerabilities, but comes with a range of risks of its own (see section II above). More generally however, concerted efforts to deepen local banking and financial systems are indeed a key mechanism to support domestic resource mobilization and private sector development, in particular where policies target the provision of long-term finance to dynamic sectors of the economy. Of special importance is the strategic coordination of monetary and fiscal policies to create conditions consistent with strong domestic investment, stable exchange rate dynamics and external debt sustainability over long periods of time. For monetary policy, it is essential to consider the full range of available policy tools, such as capital controls, as well as macroprudential measures to facilitate the simultaneous management of price, exchange rate and financial stability. In the case of fiscal policy, improved tax collection and the tackling of illicit financial outflows are essential elements of domestic policy efforts.[46] Improvements in the mobilization of domestic resources can in turn help to provide fiscal space to finance Sustainable Development Goal-related investments without undermining debt sustainability.

35. Finally, close attention should be paid to capacity-building and investment in the area of debt data quality and transparency. Improved debt data availability and quality is indispensable to the design of appropriate debt sustainability policies, whether at the national or international levels, particularly given the growing complexity of debt instruments and the need to strengthen operational risk management capacities. At present, coverage of public sector external debt in many developing countries remains incomplete, and debt data recording, reporting and monitoring mechanisms and frameworks tend to be weak for both domestic debt (including subnational debt) and private debt. Of particular concern is the accumulation of unrecorded (hidden) debt, arising from inadequate monitoring and reporting of external contingent liabilities associated with public guarantees, for example in the context of public–private partnerships, and of external liabilities issued through off-shore or off-balance sheet entities by domestic private firms. Current efforts by the international community to help improve integrated domestic debt management systems in developing countries– including the International Monetary Fund, the World Bank and the two global providers of debt recording and downstream debt management systems, the Commonwealth Secretariat and Debt Management and Financial Analysis System of UNCTAD – should be further strengthened.

[44] For example, International Monetary Fund, 2017, State-contingent debt instruments for sovereigns, International Monetary Fund Policy Paper.

[45] UNCTAD, 2017, Environmental vulnerability and debt sustainability in the Caribbean: Do we have enough tools to address catastrophic risk? Policy Brief No. 62.

[46] See TD/B/EDF/1/2.

IV. Debt crisis resolution: Improving sovereign debt restructuring mechanisms

36. In view of rising instances of high debt distress and debt default in developing countries, long-standing debates about necessary improvements to existing restructuring mechanisms for sovereign debt take on new urgency. Existing processes to deal with the resolution of sovereign debt crises are fragmented, slow and often result in unfair burden sharing and high economic, social and political costs for the sovereign debtor.[47] Incentives for debtors and creditors alike are such that delaying any official declaration of insolvency as opposed to illiquidity is paramount: Debtor States are reluctant to declare themselves insolvent for fear of triggering a financial crisis at home. Cooperative creditors have an interest in avoiding such havoc to preserve the market value of their assets. The collective suboptimal outcome is "too little, too late". Importantly, once sovereign debt restructurings get under way, a debtor has to negotiate separately with different types of creditors (bilateral, multilateral and private) for different types of debt contracts.

37. A prominent reform avenue has prioritized improvements to market-based mechanisms already in existence for restructuring sovereign debt, in particular for privately held sovereign bond debt. In addition to State-contingent debt instruments, this debate has largely focused on the increased and more sophisticated use of collective action clauses in sovereign bond issues. These are clauses included in the original debt contract that allow a restructuring to bind all creditors so long as the negotiated agreement receives a threshold level of support specified in advance as part of the contract clause. Other proposals that can be understood as market-based include efforts to clarify the pari passu (equal treatment) provision that came to attention in the context of the litigation of Argentina in United States courts until 2016.

38. Such market-based approaches have the benefit of being voluntary, of being negotiated in advance of any crisis and of allowing for gradual reform, which may be helpful in providing market stability and reducing uncertainty. While this reform avenue targets welcome improvements to private restructuring negotiations, its reach is limited to bond debt and does not apply retroactively to previously issued bonds or address problems of a potential failure in negotiations. Thus, proposals to reform collective action clauses and address the pari passu clause have had little success in limiting the role of uncooperative bondholders ("hold-outs") and of creditors specializing in distressed debt instruments. While, in the latter regard, some progress has been made at the level of national legislative efforts, this has not extended to the core jurisdictions under which relevant bond contracts are generally issued.

39. Given these drawbacks, renewed attention has been paid to more systematic approaches to reforming sovereign debt restructuring mechanisms at the multilateral level. UNCTAD has argued since the onset of the first major developing debt crises in the late 1970s and early 1980s[48] that orderly workout procedures for sovereign debt should meet two objectives: They should help prevent financial meltdown in countries facing difficulties servicing their external obligations, and they should provide mechanisms to facilitate an equitable restructuring of debt that can no longer be serviced according to the original contract. These goals need not require fully fledged international bankruptcy procedures, such as proposed by the International Monetary Fund in the early 2000s. A multilateral framework for sovereign debt restructuring can start from a few basic features:

(a) A temporary standstill for public and/or private debt, to be declared unilaterally by the debtor country and sanctioned by an independent panel to avoid conflicts of interest;

[47] UNCTAD, 2015, *Trade and Development Report, 2015: Making the International Financial Architecture Work for Development* (United Nations publications, Sales No. E.15.II.D.4, New York and Geneva).

[48] In 1977, UNCTAD called for explicit principles for debt rescheduling and in 1980, its governing body endorsed detailed features for future operations relating to the debt problems of interested developing countries.

(b) Standstills should be accompanied by exchange controls, including the suspension of convertibility for foreign currency deposits and other assets held by residents as well as non-residents;

(c) Provision should be made for debtor-in-possession financing, automatically granting seniority status to debt contracted after the imposition of a standstill, as well as for lending into arrears for financing imports and other vital current account transactions;

(d) Debt restructuring, including rollovers and write-offs, should take place based on negotiations between the debtor and creditors.

40. The United Nations Basic Principles on Sovereign Debt Restructuring Processes (2015), contained in General Assembly resolution 69/319, provide the most recent proposal for a more fully fledged framework to guide such negotiations and builds on the guidance provided by UNCTAD in its 2015 publication, *Sovereign Debt Workouts: Going Forward – Road Map and Guide*. This work appeals to five general legal principles – legitimacy, impartiality, transparency, good faith and sustainability – that provide an interpretative legal framework for a step-by-step guide to a fairer and more efficient sovereign debt workout procedure, covering all stages from the decision to restructure to preparing negotiations, the negotiations themselves and post-restructuring issues.

41. The International Monetary Fund has recently introduced welcome new provisions for debtor-in-possession financing and lending into arrears that facilitate orderly sovereign debt workouts. However, progress towards the consensual adoption and implementation of a multilateral framework for sovereign debt restructuring remains slow. This reflects conflicts of interest and a consequent lack of political consensus, as well as concerns about legal inconsistencies, high demands on institutional reform and thus the need to refine specific proposals for institutional arrangements that have the potential to improve oversight, coordination and technical support for sovereign debt restructuring processes and governance. Importantly, market-based, soft-law and formal multilateral approaches to sovereign debt restructuring should be seen as complementary rather than mutually exclusive, with a view to responding as effectively as possible to rising incidences of sovereign debt crises and minimize their impact on the implementation of the 2030 Agenda for Sustainable Development.

V. Conclusions

42. There can be little doubt that rising debt and financial vulnerabilities in the developing world currently are fast turning into a formidable obstacle for sustainable development in general, as well as for the implementation of the 2030 Agenda for Sustainable Development in particular. Amelioration of debt and financial distress requires the causes be addressed. Policy and regulatory measures that help reduce international capital flow volatility and ensure that external finance can be channelled reliably into long-term productive investment and developmental projects are paramount.

43. Relevant policy discussion and analysis of developing country debt sustainability requires a holistic approach to reform at the international, regional and domestic levels. Ultimately, attention should be focused on conditions at all levels that are consistent with two main objectives: first, to promote a return to positive net resource transfers from the developed to the developing world in the short run; and second, to ensure that, in the long run, developing countries establish the productive and export capacities required to reduce their reliance on external financing and support their own development process. The challenge of this task is that it requires not only a review and discussion of a wide range of policy options, but also the careful balancing of national policy spaces to respond to debt challenges with international regulation to support developing country debt sustainability.

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Note by the UNCTAD secretariat

Corrigendum

Paragraph 29, line 15

For Guidelines on Responsible Financing *read* Guidelines for Sustainable Financing

Footnote 41, page 10

The footnote should read as follows:

See www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Schlaglichter/G20-2016/g20-operational-guidelines-for-sustainable-financing (accessed 5 July 2018).

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Corrigendum

Page 9, paragraph 23, line 2

For developing nations *read* developed countries

Page 12, line 2 (continuation of paragraph 33)

For State *read* state

Footnote 46, page 12

The footnote should read as follows:

See TD/B/EFD/1/2.

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